“ISLAMIC BANKING: THE LESSONS AND CHALLENGES IN MALAYSIA & BEYOND”

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TODAY’s JOURNEY

- BASIC PRINCIPLES OF ISLAMIC BANKING
- ISLAMIC BANKING IN MALAYSIA – EVOLUTION & DEVELOPMENT
- ISLAMIC BANKING – MARKET OVERVIEW
- LESSONS & CHALLENGES IN MALAYSIA & BEYONDS
- MOVING FORWARDS
Section 2, IBA 1983:

“Islamic banking business” means banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam.
✓ Islamic Banking is based on Shariah Laws.

✓ The governing principles are:-

- The absence of interest-based (riba’) transactions
- Avoidance of speculations (gharar)
- Avoidance of oppression (zulm)
- Promotion of socio-economic justice via Islamic tax (zakat)
- Discouragement of the production of goods and services that are harmful to human kind (ethical business) and contradict the Islamic principles or value (“haram”)

واَحَلِّ اللَّهُ الْبَيْعَ وَحَرَّمَ الْرِّبَةَا
‘Allah has permitted trade & has prohibited riba’

-Al Baqarah 275-
"The interest which you give to increase the wealth of people, will have no increase with Allah: But that which you lay out for charity, seeking favor of Allah (He will increase): it is these who will get a recompense multiplied.” ... Ar Rum 39

“O you who believe, Fear Allah and give up what remains of your demand for Interest, if you are indeed a believer. If you do not, then you are warned of the declaration of war from Allah and His Messenger; But if you turn back you shall have your principal: Deal not unjustly and you shall not be dealt with unjustly.” ... Al Baqarah 278 - 279
Islamic Financial System

- Fairness / No Exploitation
- Materiality, Economic Purposes
- Sanctity of Contracts
- Risk Sharing
- Prohibition of Interest (Riba)
- No Financing of Activities prohibited by Islam
✓ Direct link to real economy
✓ Certainty - supported by underlying activities (avoidance of gharar - uncertainty)
✓ Prohibits excessive leveraging
✓ Money is not commodity

✓ Greater transparency & disclosure -
  - additional Shariah governance
  - unique risks
✓ Greater fiduciary duties & accountability
✓ Emphasis on clear documentation & contract add to soundness & stability

✓ Avoidance of unethical activities e.g. hoarding
✓ Avoidance of maisir (gambling) & riba (interest) & non-permissible goods & services
✓ Screening investment
✓ Forbearance for customers in difficulties

✓ Different contractual relationship
✓ Equity-based & risk-sharing transactions
✓ Clearly defined risk & profit-sharing characteristic serve as additional built-in mechanisms

‘...the traditional values of Islamic finance are growing in appeal for Western investors seeking safe haven from the current financial storms’ Source: Arthur D Little
DIRECT LINKS TO ECONOMY

- Sukuk as viable avenue for ethical investment
- Structured based on applicable Shariah contracts:
  - Sale-based (Murabahah, Salam & Istisna’)
  - Lease-based (Ijarah)
  - Equity-based (Musharakah & Mudharabah)

Underlying economic activities (e.g. manufacturing, construction & infrastructure development) gives certainty to meet Shariah requirements

Sukuk underwriting

Real economic activities

MECHANICS OF SUKUK

- Income from real economic activities is transferred to investors

Wealth generation

Multiplier effects

- Concept of income-sharing instills higher productivity
  - Real economic activities spur economic growth
  - Multiplier effects to other economic sectors

Inter linkages between Islamic finance and real economy is exemplified in Sukuk structure...

1  2  3  4
ISLAMIC BANKING IN MALAYSIA – EVOLUTION & DEVELOPMENT
MALAYSIA’s HOLISTIC APPROACH

STAGE 1
(1983 - 1992)

- Instituting Foundations
- ✓ Enactment of dedicated Acts for Islamic banking, takaful and Shariah compliant government funding
- ✓ Establishment of first full-pledged Islamic bank and first full pledged takaful company

STAGE 2
(1993 - 2000)

- Institutional Building, Activity Generation & Market Vibrancy
- ✓ Legislative amendments to allow window-concepts
- ✓ Establishment of national Shariah Advisory Council to expedite the expansion of products and services
- ✓ Establishment of the Islamic interbank money market

STAGE 3
(2001 - 2010)

- Strategic positioning & International Integration
- ✓ Creation of efficient progressive and comprehensive Islamic financial system
- ✓ Financial Sector Master Plan was launch - Malaysia as Islamic financial hub
- ✓ Establishment of Islamic Financial Services Board
- ✓ Liberalize domestic Islamic finance sector
- ✓ Integrate with Islamic finance sector
- ✓ Establishment of Malaysia International Financial Centre
BACKGROUND – ISLAMIC BANKING IN MALAYSIA

- 1960s: Tabung Haji was established in 1969... the initiatives begin.
- 1980s: First Islamic Bank i.e. Bank Islam was set up in 1983, under Islamic Banking Act 1983.
- 2004: Establishment of Islamic Banking Subsidiary for conventional bank.
- 2005: Entrance of Kuwait Finance House, Al Rajhi & Asian Finance (a consortium of Qatar Islamic Bank, RUSD Investment Bank Inc. & Global Investment House).
- 2008: International Islamic Banking licenses were issued to Unicorn International Islamic Bank, First Islamic Investment Bank Ltd (owned by PT. Bank Muamalat Indonesia) and Deutsche Bank Ag (2010), allow the bank to provide Islamic commercial and investment services denominated in foreign currencies.
- 2010: 5 new Islamic banking licenses to foreign banks (BNP Paribas SA, PT Bank Mandiri, National Bank of Abu Dhabi, Mizuho Bank and Sumitomo-Mitsui Banking Corporation) and the establishment of “Mega Islamic Bank” (to be announced).
ISLAMIC BANKING MODALITY

Broad

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<tr>
<th>Stand-alone Islamic bank</th>
<th>Islamic windows</th>
<th>Specialized institutions</th>
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<td>- Independent financial institutions</td>
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<td>- Offer full range of Islamic-compliant products &amp; services</td>
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<td>- Retail banking, wealth/asset mgmt., corporate banking advisory and capital markets trading</td>
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<td>- E.g., Bank Syariah Mandiri, Bank Muamalat Indonesia, Al-Rajhi Bank, Dubai Islamic Bank, Al-Baraka Banking Group, Kuwait Finance House</td>
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<td>- Specialized set-ups within conventional banks</td>
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<td>- Popular with global players</td>
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<tr>
<td>- Offer Islamic-compliant products &amp; services</td>
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<tr>
<td>- Generally targeted at affluent customer segments and institutional investors</td>
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<td>- Private banking, retail deposits and investments, some corporate banking services</td>
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<td>- E.g. Citibank, ABN Amro, etc</td>
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- Takaful, re-Takaful players |
  - Risk-sharing organizations that mimic the functions of insurance/re-insurance firms |
  - E.g., Syarikat Takaful Malaysia |
- Islamic mortgage companies |
  - Targeted at housing market for Muslim communities in Western countries |
  - Part of conventional mortgage companies |
  - E.g., West Bromwich Building Society (UK), Freddie Mac (US) |
- Islamic investment fund management companies |
  - Offer investments in Islamic-compliant equities (listed and un-listed) as well as in real estate |
  - E.g., Al-Tawfeek company |

Estimated 300 Islamic FIs today across 75 countries operating in various systems including dual-systems (Indonesia) and national Islamic banking systems (Iran, Sudan)
STAND-ALONE VS WINDOW

Benefits of moving from a window-based to stand-alone structure

Increased participation of foreign players (via, e.g. JVs)
- Window structure discourages investment by foreign Islamic banks as conventional bank not Sharia-compliant

Opens up possibility of listing on stock market
- Faster growth prospects than conventional banking

Greater autonomy, more visibility and increased focus
- Stand-alone will have own board, resources, capital
- Window operations restricted because of need to compete for resources with the conventional bank

 Increased talent retention
- Career progression may be limited under window structure

“If you really want to be big in Islamic banking, we have got this new option for you to set up your business through a subsidiary [as opposed to a window]”
- Deputy Governor, Central Bank of Malaysia

“Not easy to expand the market share of shariah banks, especially by only relying on office channeling [similar to window-system] since the shariah banking assets were still small compared to the total banking assets ratio”
- Director of DNI

“Even though the growth is very good for windows, sometimes there is no strategic focus”
- Deputy Governor, Central Bank of Malaysia

“In countries like Saudi Arabia and the United Arab Emirates, for instance, conventional banks converted their Islamic window operations when these outpaced growth of their conventional business”
- Citigroup Asia head of Islamic Banking
ISLAMIC BANKING
- MARKET OVERVIEW
GLOBAL MARKET VIEW

✓ Increasing universal acceptance and popularity of Islamic financial products and services as well as continuous innovation to develop globally accepted and recognized Islamic financial products and services...estimated 1.6 billion Muslims worldwide and Islamic assets are set to hit more than USD1.03 trillion by 2012 (“The Banker 2009”)

✓ Islamic finance has expanded at annual rate of 15-20% with a presence spanning more than 75 countries with more than 300 Islamic financial institutions ... robust growth

✓ Many of the world’s largest financial institutions have engaged in Islamic banking and structured financial products... growing interest


✓ Islamic private capital investments especially among the Middle Eastern high net-worth individuals (HNWIs) estimated to be worth US$1.5 trillion in 2006, to reach US$2 trillion by 2010
As at June 2009, estimated total Islamic banking assets of USD822 bil...

... total number of Islamic banks is still small and according to online-researches conducted by Shariah-Fortune estimated at around 350-400 institutions worldwide. Compared to around 9,500 banks located in the USA the Islamic Banking sector still seems pretty small.
Total global outstanding Sukuk was worth about US$106.5 bil

About 62% of the global outstanding Sukuk or US$66 bil were originated from Malaysia
MOVING INTO UNCHARTERED TERRITORIES

UK
- Govt sets an objective to ‘entrench London as a global gateway for Islamic Finance
- 5 FSA-approved Islamic banks and 2 Takaful operators

Hong Kong
- Aims to become an Islamic finance hub
- Hang Seng Islamic China Index Fund in 2007
- Shariah Advisory Council formed

Japan
- New law allowing banks to do Islamic Finance

France
- Passed rules/regulations to support Islamic finance activities
- Considering licensing first Islamic bank

Singapore
- Established first Islamic bank
- Introduced tax neutrality for Islamic finance
- Aspiring to be centre for Islamic finance
- Issued sukuk

Dubai, UAE
- Fast emerging as financial centre through DIFC aggressive promotion efforts

Indonesia
- Islamic co-operative finance & mortgage established
- Consider to establish Islamic bank

... a call for our domestic players to chart the roadmap and gear up for global business
MATURITY VS. GROWTH

Maturity Curve

Measure or success or profitability

High

Medium

Low

Early start

Take off

Fast growth

Saturation

Maturity

Islamic finance probably stands here; best time in terms of business development BUT most damaging when a crisis hits
ISLAMIC BANKING LANDSCAPE

2 Mega Islamic Banks (Paid Up Capital of US$1 bil) – August 2010

17 Commercial Islamic Banks

5 new Islamic banking licenses - subsidiary of foreign banks

STAND-ALONE
SUBSIDIARIES OF CONVENTIONAL BANKS
ISLAMIC WINDOWS & DFIs
INTERNATIONAL ISLAMIC BANKS
DOMESTIC MARKET OVERVIEW

- Islamic banking - “Banks for All”, not limited to Muslim/Malays. Build on competitiveness, innovative financial solutions and excellent service delivery.

- The Govt’s relentless drive and unwavering support to develop Malaysia as an international centre for Islamic finance.

- As at June 2010, the country’s Islamic banking system has accumulated a total RM303 billion in assets or about 19.6 per cent of the total assets of the banking sector, which is RM1.5 trillion. Islamic Sukuk garnered 57 per cent or RM172 billion of the total bond issuance of RM301.75 billion.

- Expansion “Beyond Malaysia” to strengthen regional presence and market share (Indonesia, India & China) - with greater market potential.

- Paradigm shift, from retail-based to focus on international syndication, sukuk and structured products.
As at June 2010, Islamic banking assets stood at RM303 bil as compared to Dec 2009 of RM224.9 bil.
DOMESTIC INFRASTRUCTURE

- MIFC - Malaysia as a global Islamic financial hub
- Attractive tax & non-tax incentives
- Robust & comprehensive regulatory, legal, corporate governance & Shariah framework
- Wide & knowledgeable investor base
- Adequate pool of talents & capabilities
- Continuous product innovation
- Liberal foreign exchange rules
LESSONS & CHALLENGES IN MALAYSIA & BEYONDS
LESSONS & CHALLENGES IN MALAYSIA & BEYOND

✓ Misconception against Islamic Banking
  ➢ Many still has a wrong understanding or misconception against Islamic Banking which among the thoughts are:
    ▪ Islamic Banking is only for Muslims
    ▪ Islamic Banking is not profitable because no interest is charged
    ▪ Islamic banking is only offered in the Middle East
  ➢ Thus better awareness shall be create among the customers that Islamic Banking is not only an alternative financial approach but also in some aspects provides better value propositions to the consumers.

✓ Lack of uniformity between Shariah’s view
  ➢ Divergences of opinion between the different school of law complicate the matter as do the different methodologies that may be called upon when elaborating on the law.
  ➢ Shariah interpretation versus business practicability/financing commercial viability

✓ Documentary complexity
  ➢ Customers consciousness and competition among Islamic bank will lead to standardization of Islamic financial product and documentation
LESSONS & CHALLENGES IN MALAYSIA & BEYOND...cont

✓ Moving towards equity-based financing (Mudharabah & Musharakah)

➢ Commercial banks to act as venture capital, hence requires a new set of technical and risk management capabilities i.e. industry experts and know-how

➢ Market readiness - profit sharing, trade secrets, bank as strategic business partners (potential conflicting interest).

➢ Balance sheet size, risk appetite and underwriting capabilities

➢ Supervisory and prudential regulatory framework.

➢ Accounting and auditing standards.

✓ Heightened Competition

➢ Concerns of the Malaysian banking system getting overcrowded

➢ Dynamic products & services that constantly evolve to meet the ever-changing customer needs and expectations of all walks of life

➢ Aggressive launch of innovative and sophisticated products by financial institutions puts tremendous pressures on Islamic banks
Brand Recognition - to develop Islamic banking financial solutions into a “household name” which anybody can relate to in Malaysia and subsequently, a global brand which is universally recognized and accepted:

- Retention of positive aspects of the brand name such as “a true blue Islamic bank”, wholesome Islamic values, innovative financial solutions at competitive pricing

- Avoidance of negative perceptions such as expensive but out-of-date products & services, association with adverse elements such as terrorism and money laundering
Rising Cost-to-Income ratio: Ballooning operating costs for Islamic banks as opposed to relative cost stability for the overall banking system due to:

- Higher human resources related expenditure
- Expenditure on IT infrastructure and systems
- Expenses for research & development (R&D) and product innovation
- Re-branding and branch remodeling
- Branch expansion and new delivery channels
LESSONS & CHALLENGES IN MALAYSIA & BEYOND...cont

- War of talents get fiercer
  
  - Global shortage of Islamic finance talents at almost all levels especially the middle and senior management
  
  - Inadequate pool of Shariah scholars with the right combination of knowledge in Islamic law and modern finance to serve at Shariah Advisory Committees/Boards of Islamic banks
  
  - The issue of “poaching” by competitors in Malaysia as well as by those in emerging Islamic financial hubs in particular Dubai, Bahrain, Singapore, Hong Kong and London with their lucrative packages
  
  - The need for effective ways to attract, retain and develop experts and high skilled workers

“Bank Islam is a talent developer or supplier instead of being just an acquirer of talents with its emphasis on talent development and skills enhancement. Bank Islam aims to be the ‘Employer of Choice’ in the Islamic financial services industry (IFSI)”
MOVING FORWARDS

Centre of Shariah Reference

Centre of Capital & Money Market
- Fund Management, Sukuk, Money Market instruments

Centre of Product Innovation

Diversity of players
- Domestic Players with Global Linkages
- International players

Centre of Fund Flows

Centre of Talent Development

Centre of Int’l Currency Business

Centre of Ancillary Services
- Legal, Accounting & Processing services/Outsourcing services

... Malaysia is in position of strength & has now position internationally
“Bank Islam seeks the recognition as an integrated financial solutions provider with a panoply of innovative Shariah-based financial products & services that respond to customer needs and requirements.”